Direct Lease Financing

Consider the following procedures at each examination. Examiners are encouraged to exclude items deemed unnecessary. This procedural analysis does not represent every possible action to be taken during an examination. The references are not intended to be all-inclusive and additional guidance may exist. Many of these procedures will address more than one of the Standards and Associated Risks. For the examination process to be successful, examiners must maintain open communication with bank management and discuss relevant concerns as they arise.

Leases should be evaluated in the same manner as amortizing loans. Examiners should determine that adequate cash flows are available to service the leases. In addition, leases should be included in the sample of loans reviewed. Considerations for sampling are detailed in the Loan Portfolio Management and Review Module.

POLICY CONSIDERATIONS

1 Determine if leasing policies, procedures, and practices are appropriate.

1 A Evaluate frequency and timeliness of policy reviews and updates by the board of directors.

1 B Determine if policies include the following broad areas of concern:

1 B1 1. Pre-approval and on-going review of vendors and brokers.
2. Securitization of leases, if applicable.
3. Guidelines on the allowable percent mix of leasing components (financing amount and recapture of residual value) in relation to the total cash flows.
4. Prudent underwriting standards. (Underwriting should be consistent with other lending activities.)
5. Minimum downpayment or deposit for each type of equipment or auto leased.
6. Guidelines on documentation required for each type of equipment under lease.
7. Guidelines for establishing initial residual values, periodic re-evaluations, and reacquired asset inventory.
8. Guidelines for the control, maintenance, insurance, and disposition of asset inventories.
9. Provisions for review of completed lease documents by legal counsel, including tax opinions.

DOCUMENTATION

2 Review a sample of lease files to determine if they contain proper documentation. The following items should be in the file for those banks dealing with larger leases: (Note: The following items are unique documents for lease financing. Files should also contain the standard documentation required for other types of lending, such as applications, credit reports, etc.)

2 A Master lease agreement.

2 B Lease schedule.

2 C Lessee's resolution.

2 D Lessee's acceptance form.

2 E Purchase order and purchase order requirement.

2 F Standard UCC-1 filing.

ADMINISTRATION

3 Determine if the bank has appropriate insurance on leases identified to have potential liability. (Note: As owner of the equipment being leased, the bank may be liable for claims in the event of an accident involving the equipment.)

4 Review asset acquisition and disposition records to ascertain if any conflict of interest or self-dealing involving seller, servicer, insurer, or purchaser of equipment is evident.

5 Determine if property held in inventory to be leased is accounted for and properly maintained.

6 Sample the bank's methodology for assigning initial residual values and annual re-evaluations. (Note: Inflated residual values could be a sign that the bank is aggressively pricing its leases. While the reduced lease payments may be attractive to the lessee, residual losses could increase for the lessor.)

7 Determine if management has an effective system of tracking residual gains and losses. (Note: Increasing residual losses could be a sign that pricing competition may have resulted in inflated residual values. Often banks will use a termination report that reflects all the relevant information concerning leases that have or will soon mature.)

8 Determine if direct financing leases meet the criteria for capitalized leases plus two additional criteria. (Note: If the lease cannot be accounted for as a direct financing lease, refer to Call Report instructions concerning operating leases.)

8 A A lease is accounted for as a capitalized lease if any one of the following criteria is met:

8 A1 1. Ownership of the property is transferred to the lessee at the end of the lease term.
2. The lease contains a bargain purchase option.
3. The lease term represents at least 75 percent of the estimated economic life of the leased property.
4. The present value of the minimum lease payments at the beginning of the lease is 90 percent of the fair market value of the leased property.

8 B Direct financing leases must also meet the following two criteria:

8 B1 1. Collectibility of lease payments is predicted.
2. No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease.

9 Determine if any direct financing leases are leveraged leases. (Note: Refer to the definition of "lease accounting" in the Call Report instructions for additional information.)

10 Determine if management has an effective system of tracking yields in the leasing portfolio. The yield analysis should include the following information:

10 A The contractual lease rate.

10 B Residual gains and losses.

10 C Associated tax benefits.

11 Ascertain if the bank's procedures require that depreciation expenses on operating leases be charged at least quarterly.